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October 16, 2002

**Ex Parte**

Marlene H. Dortch
Secretary
Federal Communications Commission
445 12th H Street, SW, Portals
Washington, DC 20554

Re: *Review of the Section 251 Unbundling Obligations of Incumbent Local Exchange Carriers*, CC Docket No. 01-338

Dear Ms. Dortch:

The attached letter from William Barr of Verizon was provided to Chairman Powell today. Please place it on the record in the above proceeding. Please let me know if you have any questions.

Sincerely,

Ann D Berkowitz

Attachment

cc: Commissioner Abernathy
Commissioner Martin
Commissioner Copps
B. Tramont
C. Libertelli
M. Brill
D. Gonzalez
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October 16, 2002

Honorable Michael Powell
Chairman
Federal Communications Commission
445 12th Street, SW
Washington, DC 20554

Dear Chairman Powell:

The issues pending before the Commission in its review of the unbundled network element rules are critically important to restore the long-term health of the telecommunications industry. The purpose of this letter is to propose a framework for addressing these issues.

The Commission's previous unbundling rules were based, as the D.C. Circuit has said, on the "belief in the beneficence of the widest unbundling possible." Six years of experience have refuted that belief and proven that expansive unbundling is fundamentally destructive of investment, and therefore of the long-term competitiveness and health of the entire industry.

At the very time when so many promising new information technologies are emerging, the FCC's unbundling rules and prices are affirmatively discouraging investment in this critical infrastructure. The ready availability of the incumbent's facilities deters other firms from investing in alternative facilities and technologies. Moreover, incumbents have no incentive to invest or innovate under a UNE regime that allows entrants to capture all the upside of any good investment while leaving the incumbents with the downside of investments that do not succeed.

Although the unbundling regime was intended to spur facilities-based competition, the opposite is happening under the current regime. In markets such as New York, where carriers once invested heavily to deploy their own switches, that deployment declined precipitously once carriers began the widespread rollout of services using the so-called UNE-platform. Several carriers, including one of the largest, have even begun to move customers served with their own switches to UNE-platform arrangements. Likewise, where carriers once invested heavily in facilities to serve business customers, competing carriers recently have begun to use the UNE-platform to serve business customers as well. And where carriers once invested heavily in fiber-optic facilities to provide high-capacity services, they increasingly are demanding unbundled elements instead. In fact, carriers now go so far as to demand that incumbents build new high-capacity facilities solely to make them available as unbundled elements at prices below those that they (or any other carrier) could build them. As if that weren't enough, one of the leading providers of facilities-based service to residential customers was recently downgraded due to concern that its investment is being undermined by carriers that provide service entirely over unbundled elements.

The damage already caused by the Commission's overly expansive unbundling rules sets in context the legal analysis of the Act's unbundling requirement, as interpreted by both the Supreme Court and the D.C. Circuit. Both courts recognized that limiting the extent of unbundling obligations is as important to the Act's purposes as is providing access. Those decisions make clear that unbundling rules that go too far vitiate the Act's text and purpose just as much as, if not more than, sharing obligations that are too narrow. As the D.C. Circuit put it, there "are plainly two sides to the effects on investment of ubiquitously available UNEs at Commission-mandated prices." On the one hand, the unbundling of elements that cannot be competitively provided may facilitate the efforts of competing carriers to "set about providing the other elements and offering complete competitive service." On the other hand, each "unbundling of an element imposes costs of its own, spreading the disincentive to invest in innovation and creating complex issues of managing shared facilities."

As you explained in words foreshadowing the D.C. Circuit's decision, the Commission must strike "a careful balance between aiding new entrants and not making access to the incumbent's facilities too easy." As you have noted previously, because unlimited unbundling eviscerates investment incentives and inhibits development of the form of competition that will spur innovation, provide price discipline, and otherwise provide the greatest benefit to consumers, the Act mandates that incumbents' unbundling obligations be limited to providing access only to those elements truly needed to enable the development of a competitive market.

The current proceeding provides the Commission with an opportunity to establish this critically important but currently missing balance. The following pages outline a proposed approach that takes into account the practical marketplace experience over the past six years; carries out the Supreme Court's mandate to develop a "limiting standard" that is "rationally related to the goals of the Act"; complies with the guiding principles recently set forth by the D.C. Circuit; and is consistent with the views you and your fellow Commissioners have articulated about the proper role of unbundling.

## I. Key Principles of Impairment

The Commission's initial task is to identify the core principles that will guide its determination of what elements should be unbundled.

A. <u>The Impairment Standard's Relation To Natural Monopoly</u>

**1. *General Standard.*** The touchstone of impairment under the Act is, in the words of the D.C. Circuit, whether an element "is unsuitable for competitive supply." The impairment inquiry therefore must, as the D.C. Circuit held, be "linked (in some degree) to natural monopoly" characteristics of an element. To put it in economic terms, an element may be unbundled under the statute when, in the D.C. Circuit's words, "it would make *no economic sense* for competitors to duplicate the facility" – when, for example, "average costs are declining throughout the range of the relevant market," such that an entrant with less than full market scale cannot successfully compete.

The key to the impairment analysis therefore is whether an entrant can, over time using its own facilities, profitably serve less than the entire market. Consider, for example, a metropolitan area with two million customers. Were telephone service a natural monopoly, only a firm serving all two million customers could achieve optimum scale, and smaller firms would be unable to compete. But if a competitor could build a business serving 5,000 business customers using its own loops, switching, and transport, then those network elements are in no sense a natural monopoly in that business market. Similarly, if a competitor could build a business serving one-third of residential customers with its own facilities, then the incumbent's facilities likewise lack natural monopoly characteristics in that market.

**2. *Scale-Related Costs.*** A transient cost disparity resulting from differences in scale does not meet the standard for unbundling established by the Act. The key inquiry is whether an entrant can ultimately be efficient serving its targeted market share, not whether the entrant experiences cost disparities as it ramps up toward that share. If an entrant can target less than the entire market, and ultimately serve that share efficiently without relying on unbundled elements, the cost disparities incurred along the way as the entrant builds market share in no sense mean that the incumbent's facilities have any natural monopoly characteristics. The temporary cost disparities associated with building scale therefore cannot justify unbundling.

After all, any entrant in any industry in which economies of scale exist will experience unit cost differences as it builds toward efficient scale. In a competitive, capital intensive network industry – as was the case with wireless – profitability is not generally achieved in less than 5-10 years, and economic break-even typically requires at least a decade.

It is plainly impermissible to rely on these universal cost disparities as a justification for requiring access to incumbents' facilities. As the D.C. Circuit made clear, the Commission may not interpret impairment by reference to cost disadvantages inherent in entry itself, as opposed to costs that result from the nature of the element in question. Thus, as the D.C. Circuit explained, "[t]o rely on cost disparities that are universal as between new entrants and incumbents in *any* industry is to invoke a concept too broad, even in support of an *initial* mandate, to be reasonably linked to the purpose of the Act's unbundling provisions." Instead, "impairment" must be pinned to "cost differentials based on characteristics that would make genuinely competitive provision *of an element's function* wasteful." To use UNEs as a means of defraying start-up costs or accelerating economic payback is a naked subsidy that violates the Act, because any analysis aimed at this impermissible objective shifts the inquiry from whether a market is contestable to identifying the best way to ease the contest for entrants.

If the Commission's objective is to enable entrants to build scale, the Act provides an explicit mechanism for achieving this goal: resale. Resale allows competitors to make more efficient use of their facilities as they build them, because it permits them to add customers at lower unit costs and avoid the expense of unused capacity. Although competitors commonly complain that resale is not a profitable business in its own right, this assertion misses the point. The Act's purpose in mandating resale is not to create a viable business by eliminating transient scale-related cost disparities. Rather, it is to provide a way of building scale that is less expensive than relying solely on new facilities. Thus, the FCC's prior notion that incumbents' whole network should be defined as a UNE-platform to provide another means of resale cannot stand.

**3. *Alternative Technologies*.** In determining whether an element meets the standard for unbundling, the Commission must consider the full range of technologies by which that element's *function* could be performed. The flaw in the Commission's prior approach was that it focused myopically on the extant telephone network and effectively treated it as a natural monopoly because the agency did not believe it to be feasible or efficient for an entrant to replicate that network with its copper loops and circuit switches. But the economically relevant question is whether there are alternative approaches to performing the same *function*, using any technology. That is why the D.C. Circuit said that the Commission must pin its UNE determination on "characteristics that would make genuinely competitive provision of an element's *function* wasteful." It makes no sense to say that a railroad is a natural monopoly in the cargo market, while ignoring trucks, barges, and planes. A facility is not a natural monopoly if it faces intermodal, rather than intramodal, competition.

It is especially important for the Commission to take a broader technological perspective here because intermodal competition is generally a key factor in network industries. The determination that an element has natural monopoly characteristics reflects the judgment that construction of alternative facilities should be discouraged – *i.e.*, that alternative facilities would necessarily be less efficient than shared use of the incumbent's existing plant. That is certainly not true under any reasonable definition of the telecommunications market today and in the future. The advent of IP technology and investments in cable networks have already created an alternative channel into the home that competes directly with telephony systems. Further, wireline already faces active competition from the increasing reach and bandwidth of mobile wireless, and at least three fixed wireless solutions – LMDS, MMDS, and WCS – have emerged, with Ku/Ka band satellite solutions in development. The FCC's expansive unbundling rules have already diverted capital into what the D.C. Circuit called "synthetic competition," rather than the development of these promising alternative technologies. Thus, as the D.C. Circuit held, the Commission must "consider the relevance of competition" from technologies other than traditional telephony.

**4. *Countervailing Advantages.*** The determination of whether an element can be competitively provided must not view the cost of supplying the element in isolation, but must also consider entrants' compensating advantages that render provision of such elements viable. If an entrant's cost of providing an alternative element is higher than the incumbent's, but the entrant nevertheless can profitably do so because it can sell other services, avoid other costs, or achieve qualitative advantages in a way that is not available to the incumbent, the element can be supplied competitively and unbundling cannot be required. The question is whether the entrant can provide an overall service that is competitive, not whether the cost of each input matches that of the incumbent.

The most likely entrants have scale and scope advantages that the incumbents cannot match. For example, in the national business market, the interexchange carriers already have national presence and scale, whereas the incumbent LECs are regional. Interexchange carriers also have significant scope advantages in their current service offerings. Cable operators, moreover, can provide telephony as an adjunct to services and functions that incumbent LECs are not in a position to provide.

In addition to these scale and scope advantages, competing carriers unquestionably have many other advantages. They can, for example, target their offerings exclusively toward profitable market segments. As the D.C. Circuit explained, these carriers enjoy the "advantage" of "being free of any duty to provide underpriced service to rural and/or residential customers and thus of any need to make up the difference elsewhere." Moreover, they do not face the diseconomies of scale associated with a large embedded network; they can build their networks using the most up-to-date equipment and more efficient topological designs.

The Commission itself recognized that competing carriers have such "cost advantages" in its last unbundling order, but refused to give them any weight. The D.C. Circuit's decision requires the Commission to correct this error – one that you expressly identified in your partial dissent when you highlighted the "apparent" "difficulties" of any impairment analysis that gives "almost no weight to other factors directly relevant to assessing whether a CLEC can become an effective competitor in a particular market or customer segment, such as CLECs' ability to target market and the relative profit potential of serving different types of customers." As you have explained, "meaningful, robust competition requires that rival firms vie for customers based on the distinct assets and capabilities each brings to the market."

**5. *Comparative Impairment.*** The unbundling inquiry under the Act must turn on whether a competing provider is competitively impaired *compared to the incumbent.* Burdens that both the incumbent and the entrant share are not a sufficient justification for unbundling. Thus, the fact that retail rates in many segments of the residential market have been set by regulators at artificially low levels cannot constitute impairment in any competitively cognizable sense. In such markets, as the D.C. Circuit observed, "given the ILECs' regulatory hobbling, any competition will be wholly artificial" – unless, as noted above and by the Court, "provision of service may, by virtue of economies of scale and scope, enable a CLEC to sell complementary services (such as long distance or enhanced services) at prices high enough to cover incomplete recovery of costs in basic service."

**6. *Timing.*** Some carriers have argued that certain elements, such as high capacity loops and transport facilities, should be subject to unbundling because they take time to build. The argument demonstrates why unbundling of such elements is contrary to the Act: it assumes that entrants *can* eventually deploy such elements profitably, and thus demonstrates that they are not "unsuitable for competitive supply." Entrants have had six years to build these facilities, and many have already done so. Entrants' failure to build more or different facilities may be attributable to their business plans, to the availability of other alternatives (such as special access services), to distortions of retail rates, or to other factors, but it certainly does not show that these elements have natural monopoly characteristics.

Even if the Commission were inclined to accept the "time to build" rationale – which we believe would violate the Act and conflict with the D.C. Circuit's opinion – the argument plainly does not entitle the entrants to the unbundling of elements of the incumbents' network *other* than the particular elements that entrants claim to need more time to build.

On the contrary, the entrants who advance this claim could not be allowed access to the incumbents' switching (which has been competitively deployed) based on the claim that they need more time to build their own loops. Nor could entrants who advance this claim be allowed access to the incumbents' loops unless the entrants can provide their own facilities for other elements. The only arguably legitimate reason for them to ask for use of the incumbents' loops during the time they need to construct their own is that they can use this time to deploy *other* facilities *more rapidly*. Otherwise, the entrants could simply wait to enter the market until they had deployed all of their own facilities. (Entrants might also wish to use incumbents' facilities in the meantime in order to build scale, but as discussed above, this is not a lawful basis for requiring unbundling.) Accordingly, under no circumstances may entrants obtain the UNE-Platform under this rationale.

Another implication of the "time to build" rationale is that the entrant must actually build the facilities in question within a reasonable time period specifically prescribed in advance. Absent a firm sunset for unbundling in this context, the entrants' incentive to invest will be diluted, and the entrants will return to the Commission again and again to plead for more time.

In addition, this rationale is inconsistent with TELRIC pricing. TELRIC is designed to deter uneconomic bypass, i.e., to prevent the socially wasteful duplication of elements of the incumbent's network that can be most efficiently provided by the incumbent. But the "time to build" rationale assumes that the entrant can and should eventually bypass the incumbent's network entirely, i.e., that the elements are not a natural monopoly. Setting prices at TELRIC thus sends the wrong price signal by deterring the very bypass that the entrants promise and undercutting those carriers that have already built competitive facilities.

Finally, the Commission must train its efforts primarily on the root causes of delay, rather than on a costly effort to ameliorate its effects. Thus, if the problem stems from issues with building or right-of-way access, the Commission should address those issues directly and thereby eliminate any long-term impediments to competition.

***7. Burden/presumption.*** The Commission's prior approach, which assumed that more unbundling was better, effectively led to a presumption in favor of unbundling – a presumption the incumbent had the burden of rebutting by showing that more unbundling was not needed. This approach cannot survive the D.C. Circuit's decision, which compels the opposite presumption. That Court held, in keeping with the terms of the Act, that it is the decision to unbundle that must be justified – that an element can be unbundled only if the Commission makes a determination that the significant inherent costs of unbundling are outweighed by the need for and benefit of unbundling a given element.

Under the express terms of the Act, the burden therefore rests on the proponents of unbundling, and ultimately the Commission, to demonstrate that the impairment standard has been satisfied for a particular element in a relevant segment of the market. A finding of impairment is an absolute statutory prerequisite to an element's unbundling, and the Act allows the Commission to impose an unbundling obligation only *after* it finds – based on substantial record evidence – that competing carriers would be impaired without access to a given element.

### B. The Fallacy of the "Least Common Denominator" Approach

In determining whether to require unbundling, the Commission has previously used a "least common denominator" standard that is fundamentally inconsistent with the Act and destructive of investment in alternative facilities. The FCC's test has been that if there is *any* would-be entrant who would need access to succeed, the UNE must be supplied. Thus, the FCC, while acknowledging that some entrants do not need certain UNEs, has justified their unbundling on the grounds that others may need them. But this is the exact reverse of the inquiry mandated by the Act: the question is whether there are some who could succeed without UNEs, not whether there may be some whose success might depend on them.

The purpose of the UNE regime is to remove any natural monopoly barrier that would otherwise preclude the development of competition in the market. The inquiry must therefore focus on whether there are *any* entrants in a position to contest the market without obtaining access to the incumbent's network element. If there are firms so situated, then lack of access is not a barrier to the evolution of competition. To continue to make UNEs available because one can hypothesize another entrant who could not make it otherwise is not only unnecessary, but is affirmatively harmful by discouraging investment by those entrants who could have done without.

In this market, as with any other, the entrants most likely to succeed are those who bring certain assets and advantages to the contest – scale, scope, customers, and technologies in related markets. The evaluation of need must focus on these entrants, not those who would have the highest hill to climb. In network industries, the need to recover huge capital outlays typically results in a few large competitors, and competition is often intermodal. Thus, it is not surprising that ILECs now face competition from cable and mobile wireless, and will soon from fixed wireless and satellite. Indeed, because telecommunications is an investment-intensive business, and because competitors must achieve some scale in whatever segment they target to succeed, the market cannot reach a stable equilibrium if the Commission aims to maximize the number of competitors. The FCC has no warrant to artificially augment entry based on its own preconception of a better scheme of competition than the one that is naturally arising.

To understand this point, it is instructive to look to the regulation of cable television. Cable faces no wholesale regulation, and was relieved from virtually all retail regulation based solely on the entry of satellite. You yourself recently described video distribution as "a vibrant competitive market," even though consumers typically have a choice between only a single cable operator and two satellite providers. Moreover, under the Commission's own rules, cable operators are subject to "effective competition" – and the last vestiges of retail regulation are eliminated – when an ILEC takes its first step into their local markets. By the same token, incumbent LECs are subject to extant or imminent entry from cable operators, and today face far more competitive discipline from wireless telephony than cable operators do from satellite. Here, as there, the Commission should allow competition to unfold, rather than seek to manufacture synthetic competitors.

### C. The Proper Definition Of Markets

Any determination of impairment must be based on an economically relevant market definition. The D.C. Circuit's decision requires the Commission to base its unbundling rules on "market-specific variations in competitive impairment." This inquiry requires precisely the same market definition analysis that has traditionally been applied in the antitrust context. It has three dimensions, each one of which is separately relevant to the Commission's application of the impairment standard: customers, products, and geography. Each dimension is critical, because the task at hand is to ensure the proper flow of capital for both entrants and incumbents, and investment decisions are driven by economically relevant markets and not by artificial regulatory categories.

When defining markets, there are two equal sins – overinclusiveness and underinclusiveness. One of the Commission's previous errors was to require unbundling in all markets merely because an element was deemed competitively unavailable in some markets. For example, the Commission defined a national market for switching, and found that because it might be needed in some areas it must be unbundled everywhere. This was a sin of under-granularity. As the D.C. Circuit held, the Act does not permit a universal "finding of material impairment where the element in question – though not literally ubiquitous – is significantly deployed on a competitive basis" in some geographic markets. Simply put, the Commission's unbundling rules cannot be "detached from any specific markets or market categories." In this way, the Commission's market definition must be granular enough to conform to the way that elements are used and decisions about investment are made in the marketplace.

But the Commission must also avoid the mirror-image problem of adopting a market definition that is *too* granular to be economically relevant. This error underpinned the Commission's line sharing order, which focused narrowly on the needs of those entrants who wished to provide DSL, without considering the broader market of broadband services. The D.C. Circuit rejected the Commission's over-granular definition of the product market as a "quite unreasonable" construction of the Act.

The Commission must avoid the same error in its geographic market definitions. The disaggregation of an economically relevant geographic unit into even more granular segments – from a metropolitan area to a central office to a city block – distorts the impairment analysis. Perhaps some self-interested parties would fancy a door-to-door analysis of the availability of elements, but potential investors in new facilities for entrants and incumbents would rush the exits.

Once the exercise of market definition is complete, the Commission must establish unbundling rules based on reasonable inferences from the evidence of competitive deployment. In markets where competitors have deployed their own facilities to substitute for an element of the incumbent's network, the Act precludes the element's unbundling. In markets where an element has not yet been widely deployed by competitors, however, unbundling cannot be presumed or automatic. As you explained in your partial dissent, "evidence of CLEC [facilities] deployment strongly suggests that CLECs are not significantly impaired without access . . . both in areas in which CLECs have deployed [facilities] *and areas in which they have not done so.*" The Commission should treat like markets alike, whether or not deployment patterns in those markets are the same.

D. A National Policy

The Act expressly assigns to *this Commission* the task of determining what elements must be made available on an unbundled basis, and once the Commission makes that determination, it cannot be countermanded by the states.

The Act expressly precludes the states from requiring an element to be unbundled once the Commission has determined that it does not meet the impairment standard. The Act preserves state authority to issue *only* those rules that are "consistent with the requirements" of section 251 *and* that would not substantially prevent achievement of the purposes of the 1996 Act. As both the Supreme Court and the D.C. Circuit have held, both the text and purpose of section 251 are violated whenever incumbents are required to unbundle elements for which the impairment test is not satisfied. As the D.C. Circuit explained, the Act permits unbundling only when the benefits – more rapid deployment of other facilities by entrants – outweigh the costs – the reduced incentive for innovation and investment. For a state to require unbundling in circumstances that the Commission has already determined do not meet the impairment standard would conflict with the balance established by the Act.

In fact, a national checkerboard of different unbundling rules would conflict with the statutory balance even more than an erroneous determination by the FCC. Allowing each state to require unbundling even of those elements the FCC has determined need not be provided is antithetical to the stability and predictability necessary for innovation and investment. For this reason, the Act expressly gives "the Commission" – not the states – supremacy in "determining what network elements should be made available" on an unbundled basis. And the states cannot preempt that determination once the Commission has made it.

Likewise, once the Commission has determined that there is no impairment with respect to an element, it cannot compel the former Bell companies to unbundle that element under section 271. Doing so would be antithetical to the Act's text and core goals, and imposing more stringent unbundling requirements on the Bell companies would be particularly illogical because their local markets typically are more competitive than those of smaller incumbents. At a minimum, therefore, the Commission should forbear from applying a separate unbundling requirement under section 271 where that section has been "fully implemented," as is true where a former Bell company has received interLATA authority.

II. Specific Unbundling Requirements

As noted above, translating these principles into specific rules requires a three dimensional analysis that takes into account the characteristics of specific market segments. For example, the Commission itself has recognized that the analysis may be different for business customers than for residential customers, for special access services than for local services, and for traditional dedicated services than for traditional switched services. Each of these segments is addressed below. For purposes of this letter, I have focused on the subset of issues of most central importance to providing economically rational investment incentives and to restoring the financial health of the industry; additional issues are addressed in our prior filings in this proceeding.

### A. Traditional Business Services

Within the traditional business segment of the market, the Commission has recognized that large or "enterprise" businesses are a distinct class of customers from other "general" business customers. Likewise, the Commission has recognized that already competitive special access services are a distinct market segment from other traditional telephone services.

Accordingly, an analysis of the traditional business services segment must take these distinctions into account, and must begin by categorically excluding enterprise customers and special access services from the scope of any unbundling requirements.

#### 1. Enterprise Business Segment

The enterprise segment of the traditional business market consists of the largest business customers, which typically operate at multiple locations nationally and typically spend hundreds of thousands of dollars (or more) annually for telecommunications services. These customers are highly sophisticated, typically employ their own telecommunications managers or consultants, and generate sufficient, concentrated demand to warrant deployment of competing facilities. As a result, this is the first customer segment that was targeted by competing carriers for service on a facilities basis. In fact, this is the very customer class that was the focus of so-called competitive access providers even before the passage of the 1996 Act, including companies such as MFS and TCG before they were bought by the major long distance carriers.

The enterprise segment of the market unquestionably is suitable for competitive supply, and access to unbundled elements is wholly unnecessary to serve this class of customers. Indeed, the major long distance carriers already control the vast majority of the national market for enterprise customers. To cite just one example, these customers are heavy users of packet switched services such as ATM and Frame Relay, and the major long distance carriers control roughly two-thirds of the nationwide market for these services. And other carriers serve these customers almost exclusively without using unbundled elements. Instead, they rely on their own facilities, supplemented as needed by special access services purchased from the local incumbents or from other providers at competitive rates.

In contrast, incumbent local carriers such as Verizon are at a significant competitive disadvantage in this market segment. These customers operate on a national basis, and want suppliers who can provide a full range of local and long distance services nationally and who control their own facilities. Unlike the major long distance carriers, the operations of incumbent local carriers are limited to specific local or regional areas, and the largest local carriers have been unable to provide critically important long distance services. For this reason, as WorldCom's Chief Marketing Officer has explained, "Bell companies don't present a major threat to WorldCom, Inc.'s business service group" because they "don't have the products, systems, or sales forces to attack the middle and high-end segments of the business-service market."

As a result, competing carriers self-evidently are not competitively impaired without access to unbundled elements in this market segment, and there is no plausible case for imposing an unbundling requirement to serve these customers. Doing so also would have severe harmful consequences. As the Commission itself previously recognized in the context of already competitive special access services, imposing an unbundling requirement in the presence of existing facilities-based competition would undermine that existing competition, and would risk snatching defeat from the jaws of victory. And because this market segment initially drives much of the innovation that occurs in the industry, imposing an unbundling obligation to serve these customers would likewise undermine the development of innovative new technologies and services.

2. Special Access Services

The Commission previously has recognized that dedicated special access services comprise a distinct market segment that is subject to extensive competition. Of course, where services already *are* being supplied on a competitive basis, they unquestionably are *suitable* for competitive supply. Accordingly, under no circumstances may competing carriers be permitted to substitute unbundled elements for special access services – regardless of whether those elements are purchased individually or in combination.

Special access services consist of the various dedicated facilities that run from a business customer to a carrier's point of presence. The customers for special access are long distance carriers and large business customers with sufficiently high call volumes to justify the use of dedicated facilities. Demand for these services is highly concentrated, with 80 percent of special access revenues being generated from fewer than one-quarter of wire centers. Competitors therefore can address this market with a limited, targeted investment.

The special access market is highly competitive. It was among the first to be opened to competition before the 1996 Act was passed, and facilities-based competitors already have captured a third or more of the market. Indeed, special access competition is so robust that the Commission has granted pricing flexibility in MSAs that account for a significant majority of special access demand. The Commission did so, moreover, precisely because it determined that these services could be competitively supplied, and that market forces could be safely relied upon to produce competitive rates. The D.C. Circuit, of course, agreed completely.

Given all of this, competing carriers unquestionably are not impaired in their ability to provide special access services without access to unbundled elements. In contrast, as the Commission itself recognized in its most recent order on the subject, permitting unbundled elements to be used to provide these services would "undercut the market position of many facilities-based competitive access providers," thus jeopardizing "a mature source of competition in telecommunications markets."

Accordingly, under no circumstances should competing carriers be permitted to substitute unbundled elements for special access services. To the extent the Commission retains an unbundling obligation for any of the underlying elements used to provide special access services, the Commission therefore must also limit the use of those elements to providing local (rather than special access) service. As is explained below, however, the high capacity facilities used to provide special access should not be subject to an unbundling requirement regardless of the type of service involved.

3. General Business Segment

The general business segment of the market also is characterized by significant competition and in many respects is clearly suitable for competitive supply. Competing carriers already serve some *20 million* business lines using some or all of their own facilities – including more than *160 million* voice grade equivalent circuits – and, overall, serve between *26 and 33 percent* of the business lines in the country.

With respect to traditional dedicated services, just as other carriers are not impaired in their ability to provide special access services without access to unbundled elements, the same is true of high capacity facilities that are used to provide predominantly local services. And with respect to switched services, competing carriers are not impaired without access to unbundled switching or the so-called UNE-platform.

**a.** ***High capacity transport, loops and dark fiber***. Just as facilities used to provide dedicated special access services are suitable for competitive supply, so too are dedicated high capacity facilities used to provide local (rather than special access) services.

The facilities used to provide high-capacity dedicated transport and loops are essentially the same as the facilities used to provide special access service, and the customers are the same types of entities – sophisticated, high-volume users with concentrated demand. The fact that these facilities are suitable for competitive supply is best evidenced by the fact that competing carriers already serve a third or more of all special access services, which are just a combination of high capacity transport and loops, without using unbundled elements.

Not surprisingly, therefore, competitors have focused heavily on high capacity services, and have succeeded in providing them without using unbundled elements. Indeed, competing carriers provide more than *160 million* voice grade equivalent circuits, the majority of which are provided over high capacity lines. In order to do so, they have deployed almost *184,000 fiber route miles* and built hundreds of alternative local fiber networks, with many MSAs served by *ten* or more competitive fiber networks. Carriers also are using alternative technologies, such as terrestrial wireless, to provide high capacity services.

Special access services also are an alternative for use in providing high capacity services, and competing carriers can and do compete using special access services (provided by incumbents or competitive access providers) to supplement their own facilities. Indeed, competing carriers themselves have repeatedly conceded in their filings with the Commission that they use special access services purchased from incumbents to serve their own customers. And they do so for literally untold millions of voice grade equivalent lines.

Indeed, given the ubiquitous availability of special access as an alternative, the issue with high capacity facilities comes down purely to one of price. And on that score, there is no question that competing carriers can provide high capacity services in the same way competitors initially entered the long distance business. There, competing carriers relied initially on services purchased from AT&T under volume and term discount arrangements until they completed the build out of their own facilities. Likewise, special access services are available under tariffs that include volume and term discounts, and carriers have the same ability as they do in the long distance market to use these arrangements to supplement their own facilities as they complete the build out of their networks.

It is especially ironic that other carriers would claim they need an additional price break for high capacity services. As an initial matter, the Commission itself originally adopted the tariffed rates for these services as proxy prices for the corresponding network elements based on its conclusion that the rates already reflected forward-looking costs under its "new services" test. In addition, some of the same carriers that now claim they need an extra price break previously challenged special access prices on the grounds that they were too *low* and would undermine competing providers. But most fundamentally of all, the Commission since has concluded that these services not only are capable of being competitively provided, but also that the bulk of these services already are sufficiently competitive that the market can be relied upon to produce competitive rates. As a result, requiring an additional price break would produce rates that are manifestly *below* competitive levels – a result that unquestionably would destroy incentives to invest and deploy facilities more broadly.

For these reasons, the Commission should adopt the following rules:

***DS-3 facilities and above.*** Transport and loop facilities used to provide services with a capacity of DS-3 or greater (whether lit or dark) should not be available as unbundled elements anywhere. These facilities are used to provide the highest capacity services to customers who generate traffic volumes that are more than sufficient to justify building facilities to reach them. Indeed, each individual DS-3 circuit is capable of providing the equivalent of 672 voice grade circuits. And while competing carriers have focused on providing high capacity services, they have done so without relying on unbundled elements. Indeed, competing carriers have purchased only 140 DS3 loops from all the Bell companies combined and not a single loop above the DS3 level.

***DS-1 facilities.*** High capacity transport and loops facilities used to provide service with a DS-1 capacity (whether lit or dark) are similarly capable of and are being competitively supplied, with each individual circuit providing the equivalent of 24 voice grade circuits. In addition, special access is a ubiquitous alternative where competing carriers have not yet built out their own facilities.

Thus, as an initial matter, DS-1 transport and loop facilities (whether lit or dark) should be conclusively unavailable as unbundled elements: (a) in areas where the Commission has granted petitions for special access pricing flexibility; (b) in the case of transport facilities, where there are two or more collocated facilities-based competitors in wire centers on either of the end points of a given circuit, and (c) in the case of loop facilities, where there either are two or more collocated facilities-based competitors in a wire center, or where a given customer or another customer at the same location already is being served by a competing carrier using its own facilities or the local incumbent's (or another carrier's) special access service.

The reasons are straightforward. Where the Commission has granted pricing flexibility for the portion of a special access circuit that corresponds to transport or loop facilities respectively, it already has concluded that these facilities are capable of being competitively supplied throughout that area (and that market discipline will ensure competitive rates there). In addition, where competing carriers already have a facilities-based presence at one or both ends of a given circuit, they clearly are capable of deploying competing facilities. And, of course, if a carrier does not yet have its own transport facilities along a given route, special access service remains available as an alternative. Likewise, where a competing carrier already is using its own facilities or special access service to serve a particular location, it obviously does not need unbundled elements to do so. In contrast, imposing an unbundling obligation under these circumstances would severely undermine incentives by all facilities-based providers to invest to extend the reach of their facilities or to innovate.

Outside of these areas, DS-1 facilities should be presumptively unavailable as unbundled elements. The Commission may, however, choose to make these facilities available for a limited time where a competing carrier shows that certain criteria are satisfied. Specifically, to obtain access to a DS-1 *transport* facility, a carrier must show that it cannot obtain collocation in or conduit into a given wire center, and that no alternative facilities provider has facilities within half a mile of the wire center. In order to obtain access to a DS-1 *loop* facility, a carrier must show that the local incumbent is the only facilities-based provider serving the particular location at issue and that the building owner (as opposed to the customer) has refused to provide the competing carrier with access to the building. These criteria will protect against any possibility that a competing carrier might be barred from reaching particular locations as they work to extend the reach of their own networks.

**b.** ***Traditional switched services.*** In the traditional switched segment of the business market, competing carriers plainly are not impaired without access to unbundled switching or the UNE-platform, and the requirement to provide them should be eliminated immediately for all business customers.

The case on this score is compelling and the key facts are not disputed. Competing carriers already have captured up to a third of the business access lines in the country, almost entirely through the use of some or all of their own facilities or through resale. They have deployed more than *1300* circuit switches (and thousands more packet switches), and already use those switches to serve approximately 20 million business lines. Moreover, they are capable of (and are) using these switches on a widespread basis. Indeed, collocation is now ubiquitously available, and competing carriers have obtained some *25,000* collocation arrangements. As a result, they now use their own switches to serve customers in wire centers that contain *86 percent* of all Bell company access lines, and *96 percent* of all Bell company access lines in the top 100 MSAs. Several carriers also have admitted on the record that they use their own switches to serve even the smallest business customers. And, of course, business services face rapidly increasing competition from wireless, e-mail and instant messaging, which are displacing both lines and millions of switched minutes of use from the local incumbents.

In the business market, moreover, resale is a viable alternative that allows carriers to establish a customer base while they deploy their own switches. Because retail rates for business customers are higher than for residential customers, the margin produced by the wholesale discount is larger. Businesses also are heavy users of other value-added services and of long distance services that further increase the margin available to carriers serving these customers. As a result, competing carriers previously have used resale as a way to serve literally millions of business customers nationwide.

Nonetheless, as prices have been ratcheted constantly lower in state pricing proceedings and in section 271 proceedings, competing carriers in recent months have begun to submit UNE-platform orders in significant volumes for business customers. In fact, some carriers have begun to actually move customers that they were serving using their own switches to UNE-platform arrangements. And carriers also have migrated many of the customers they previously served through resale to UNE-platform arrangements solely to take advantage of the steeper discounts that are available that way.

The Commission must eliminate the unbundled switching and UNE-platform requirements for use to serve business customers now, before they further undermine facilities-based competition as they have in the residential segment of the market.

B. Traditional Residential Services

In the residential segment of the market, competing carriers likewise are not impaired without access to unbundled switching or the UNE-platform, and the Commission should so find. As a purely transitional measure, however, the Commission may opt to provide carriers with a reasonable period during which the prices for platform arrangement will move to the resale rate. This will allow carriers the option of migrating customers to their own switches, as they claim they want to do, or of keeping their existing arrangements in place at the resale rates prescribed by Congress.

As in the business market, the case for eliminating the unbundled switching and UNE-platform requirements in the residential market is compelling. Competing carriers already serve at least *three million* residential customers with their own switches. While these carriers tend to target the highest value customers with broad packages of services, they are capable of providing service to many more. As noted above, competing carriers collectively now provide some form of local service using their own switches in wire centers that account for *86 percent* of all Bell company access lines and *96 percent* of those lines in the top 100 MSAs. In fact, cable companies alone now offer local telephone service to more than *10 million* U.S. homes and have enjoyed great success in signing up customers. AT&T and Cox, for example, have disclosed that they already have achieved penetration rates of up to *30 to 40 percent* in some areas, and are adding roughly one million new customers every year. And several cable companies are now actively conducting trials of local telephone service using IP technology in anticipation of deploying these services more broadly. As in the business market, moreover, wireless services also are an increasingly potent competitor, diverting billions of minutes from wireline networks and replacing both primary and secondary lines at an accelerating rate. Again, as in the business market, non-traditional services such as e-mail and instant messaging are diverting still further minutes.

To the extent that carriers claim they cannot economically provide residential service using their own switches, that is a function of the retail rates set by state commissions. The local incumbents face the same problem, of course, so that claim does nothing to show that other carriers are impaired *competitively* compared to the incumbent. That is why the D.C. Circuit held that the mere fact that retail rates are subsidized in the residential market cannot be the basis for a finding of impairment. In contrast, the fact that competitors are using their own switches to serve some *20 million* business customers and selectively to serve *three million* additional residential customers shows that switching is in fact capable of being competitively supplied where retail rates are compensatory.

Nor is there any merit to the claim that carriers are relying on the platform only as an initial entry strategy before transitioning customers to their own facilities. In the three years since these carriers began using the platform extensively, there is no evidence whatsoever that they have done so on a widespread basis. On the contrary, the opposite is happening. Carriers instead are expanding their reliance on the platform even where they have their own switches, and, as noted above, several carriers (including one of the largest) have sought to move customers off their own switches and on to the UNE-platform. And as any number of independent analysts have pointed out, this ever increasing reliance on use of the platform at deeply discounted rates is undermining investment by incumbents and competing facilities-based providers alike. In fact, as noted above, one of the principal competing providers of facilities-based service to residential customers was recently downgraded for precisely this reason.

Accordingly, the Commission should find that competing carriers are not impaired without access to unbundled switching or the UNE-platform. As a purely transitional measure, however, the Commission may choose to establish a reasonable transition period to phase out their availability for residential customers. If it does so, the Commission should transition the rates for these arrangements to the resale rate over a 12 month period. One-third of the differential between the UNE-platform rate and the resale rate should be eliminated immediately, another third after 6 months, and the final third after 12 months. This transition period would provide carriers with more than adequate time to do what they now claim they want to do, and migrate the embedded base of customers to their own switches through bulk transfer procedures. Moreover, by transitioning to the resale rate in stages starting immediately, carriers will have an incentive to begin the migration process immediately rather than wait until the end of the transition period. After that time, carriers may choose to negotiate market rates for these arrangements, or to take advantage of the resale rate. And to avoid exacerbating the problem during the transition period, competing carriers should not be permitted to add new customers using the UNE-platform after the initial 6-month period.

Of course, as you have noted on multiple occasions, correcting the current unbundling rules will not itself address the underlying core problem in the residential market segment of artificially low retail rates. Accordingly, the Commission also should urge state commissions to use the transition period as an opportunity to address this issue as commissions in states such as New York and Massachusetts have begun to do. Rationalizing both the unbundling rules and the regulation of retail rates will promote further investment by all potential providers and lead to the development of a healthy competitive market.

C. Broadband Services.

As Verizon and others have explained at length in connection with the Commission's various broadband-related proceedings, the country is in desperate need of a comprehensive national broadband policy that relies on the unfettered market to promote investment and innovation – a market that is free of the current one-sided regulatory constraints that apply only to local telephone companies.

We continue to believe that the best way for the Commission to establish such a policy is to start fresh by classifying *all* broadband services – *including both bundled high-speed information service offerings and stand-alone transmissions services* – under Title I of the Act. Among other things, doing so would make clear that broadband services and facilities are not subject to unbundling requirements. Regardless, even if the

Commission were to classify some broadband as common carriage subject to Title II, there still would be no basis for imposing an unbundling obligation under the impairment standard in the Act.

As an initial matter, the Commission itself has correctly recognized that broadband services are part of a distinct market that must be analyzed separately from traditional telephone services. Within the broadband market itself, there are two distinct classes of customers: larger business customers and mass market customers (which include both residential and smaller business customers). In each case, local telephone companies are decidedly minority players challenging competitors who already dominate the market, and there is no basis for imposing an unbundling obligation.

***Larger business customers.*** In this segment of the market, the local incumbents are at best secondary players. The leading providers of the relevant services – predominantly ATM and frame relay – are the major long distance carriers who collectively control roughly two-thirds of the nationwide market for these services. They do so, moreover, without relying on unbundled elements. Rather, they use a combination of their own extensive long-haul networks, their own local distribution networks (including fiber and terrestrial wireless links), and special access circuits leased from either the local incumbents or alternative sources. And where, as here, other providers dominate a segment of the market without using unbundled elements, there is no conceivable basis for a finding that they are competitively impaired without access to unbundled elements to serve these customers.

***Mass market customers.*** In the mass market segment, the Commission itself repeatedly has found both that the market is developing on a competitive basis and that cable companies are dominant. The local telephone companies again are secondary players, with barely half the market share of the dominant cable companies. In addition, competition is emerging from at least two other independent platforms (satellites and terrestrial wireless). And all of these competing facilities-based platforms offer service that is more widely available than the DSL service provided by local telephone companies.

Moreover, while cable and satellite-based providers initially focused on residential customers – and cable companies alone now have more than *10 million* subscribers and offer service to *more than 75 million* homes – they also are now aggressively pursuing business customers. For example, a recent Yankee Group report found that cable companies already had obtained *more than 500,000* business subscribers to cable modem service by the end of 2001. And satellite-based providers, who rolled out two-way services earlier this year, now offer broadband services tailored to the business market as well.

As Dr. Alfred Kahn put it, "the very idea of maintaining and expanding unbundling obligations at TELRIC rates for ILEC services, when these not only face stiff competition but have only one-half the market share of their major, unregulated rivals, who are subject to no such obligations cannot possibly be compatible with the spirit of the Telecommunications Act." The D.C. Circuit confirms that it is not: "nothing in the Act appears a license ... to inflict on the economy the sort of costs [engendered by unbundling] under conditions where [the Commission has] no reason to think doing so would bring on a significant enhancement of competition."

Indeed, imposing one-sided unbundling requirements on the new entrants into this market segment would serve only to undermine investment incentives, and impede continued development of competition to the dominant cable incumbents. Accordingly, the Commission should decline to impose such a requirement for use in providing broadband services. In particular, it should decline to re-impose a line sharing requirement, eliminate the requirement to provide collocation at the remote terminal, decline to impose an unbundling obligation on packet switches and other advanced service equipment, and decline to impose an unbundling obligation on fiber-loop facilities for use in providing broadband services.

I look forward to further discussion of these issues with you.

Sincerely,

WPBarr

William P. Barr

CC:

Commissioner Abernathy
Commissioner Martin
Commissioner Copps
B. Tramont
C. Libertelli
M. Brill
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B. Olson
T. Navin